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## Paying the Price for Internal Control Deficiencies

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### Weak Internal Controls Lead to a Higher Cost of Capital, Lower Stock Price According to New Studies

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#### Overview

The implementation of Section 404 of the Sarbanes-Oxley legislation has been the subject of furious debate amongst corporations, auditors, regulators and others. The costs have been extremely high, especially for small companies, and early results left the benefits unclear. The debate over Section 404 was brought to a head last week, as the SEC and the PCAOB jointly hosted a day long roundtable on May 10<sup>th</sup>.

While 404 costs have been easier – and painful – to calculate, until recently the benefits have been less clear. Beyond the warm and fuzzy belief that corporations and their stakeholders, particularly investors, are well served by “better controls,” the impact of 404 has been harder to quantify. This is changing.

A growing body of academic and professional research supports the finding that lack of transparency in accounting and corporate governance has a very significant cost attached to it. Recent research now concludes that corporations with Internal Control Deficiencies (ICDs) as defined by section 404 – companies which are naturally more susceptible to accounting irregularities – pay the price through:

- Higher cost of capital
- Lower stock price returns

This paper will summarize those results and address the follow-up question – how can you identify companies which are more likely to have Internal Control Deficiencies?

#### The Cost of Poor Controls

By any measure, the costs of complying with Section 404 have been high. But what of the benefits? Audit Integrity believes that as the impact of 404 is felt in the coming years, the benefits will be clear. Companies with strong levels of transparency will be rewarded, while those behaving opaquely will suffer.

“... firms that have strong internal controls ... are rewarded with significantly lower cost of capital...”

- The Effect of Internal Control Deficiencies on Firm Risk and Cost of Equity Capital, April, 2006, Ashbaugh-Skaife, et al

Ultimately the goal of Section 404 is to enforce strict rules which require management to monitor internal controls to prevent fraud. The added risk of fraud and accounting irregularities for companies with control deficiencies have a tangible impact on U.S. capital markets according to both academic and professional research. Two studies were released recently (in time for the 404 Roundtable) which support that premise.

An academic paper entitled “*The Effect of Internal Control Deficiencies on Firm Risk and Cost of Equity Capital*”<sup>1</sup> comes to the conclusion that:

“We document that firms that have **strong internal controls** or firms that remediate prior internal control weaknesses, as evidenced by an unqualified SOX 404 audit opinion, are rewarded with a **significantly lower cost of capital.**”<sup>1</sup> (italics added for emphasis)

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Further,

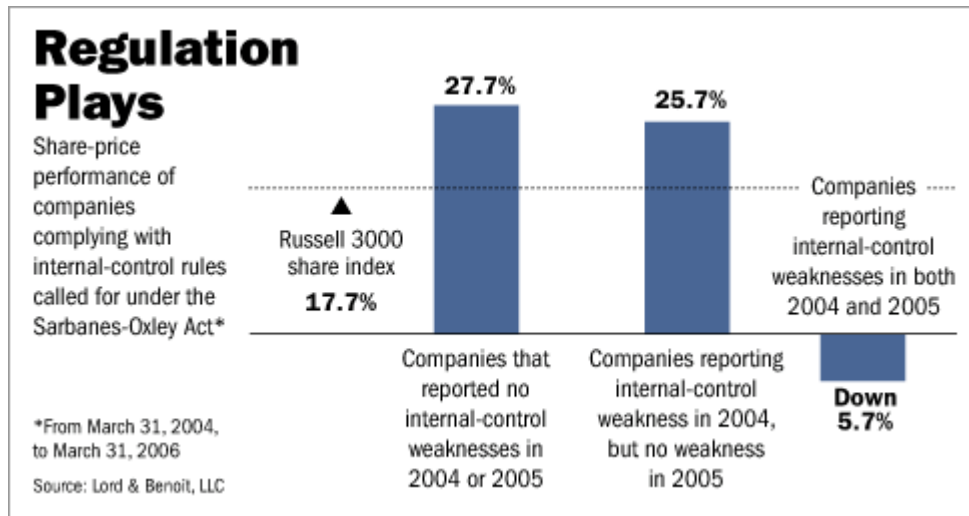
"The magnitude of the cost of equity capital effects of the internal control deficiency are economically important ranging from **50 to 150 basis points** depending on the analysis. Our study provides evidence that internal control risk matters to investors and that firms reporting strong internal controls or firms that correct prior internal control problems benefit from lower costs of equity capital beyond that predicted by other internal control risk factors."<sup>1</sup> (italics added)

The conclusions drawn from the research are given a reasonable conceptual framework when the authors state that, "Overall, the results of our cross-sectional and change analysis tests are consistent with strong internal controls being valued by the capital market."<sup>1</sup>

If the cost of capital phenomenon exists, the results should be expressed through stock returns. An article published last week in the Wall St. Journal cites a study done by Lord & Benoit LLC. Again, the incidence of ICDs was used to separate the good corporations from the bad. The research found that "shareholders benefit when companies perform checks on their internal controls: Those companies whose houses are in order enjoy market-beating gains in their share price. Conversely, the stocks of companies with weak internal controls underperform the market."<sup>3</sup>

**Figure 1** below demonstrates the equity return differences.<sup>3</sup>

**Figure 1: ICDs Affect Equity Returns**



Companies reporting no problems in either 2004 or 2005 showed an **average share-price gain of 27.7%**. That compared with a 17.7% gain for the Russell 3000.

Companies that reported ICDs in both 2004 and 2005 saw an **average share-price decline of 5.7%**.

### The Market Speaks

Concerns over costs are well known and often vociferous. Market participants, however, are well aware of the **benefits** of strong internal controls. At a recent panel discussing the needs of the market relative to internal controls, Gregory Jonas, managing director of accounting specialists group at Moody's Investors Service said that 404 still needs to "turn up the noise on controls that prevent and detect fraudulent financial reporting. This is the critical area [that] would give us more comfort to know folks are really working at these fraud-related controls."

"... [404] needs to turn up the noise on controls that prevent and detect fraudulent financial reporting..."

- Greg Jonas, Moody's Investors Service

Representing institutional investors, Michael McConnell, managing director of Shamrock Capital Advisors, cited the preliminary benefits investors are witnessing include enhanced transparency, improved corporate governance, better business processes and financial statements. “Those improvements can be noted in the higher market multiples compared with three years ago, which indicate a lowering cost of capital”, said McConnell.”<sup>2</sup>

Increasingly strong evidence supports the premise that capital markets react in a substantive way when a firm is found to have control deficiencies. How, then, to identify companies more likely to suffer potential ICDs and avoid or anticipate the negative market reaction?

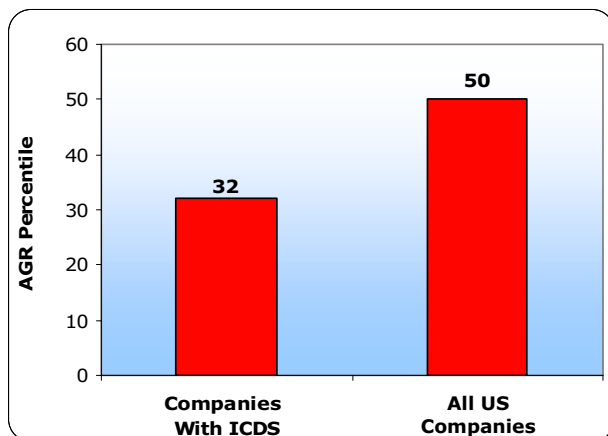
### Identifying ICDs with AGR™

Prior research has shown that Audit Integrity risk ratings and analysis are predictive of fraud (SEC enforcement actions), class action litigation, material financial restatements and equity returns (research available on request.) In short, aggressive or misleading corporate behavior as measured by a comprehensive analysis of accounting and governance factors is predictive of negative events which have a substantial impact on a corporation and its shareholders.

The proprietary Accounting and Governance Risk (AGR™) rating encompasses measures of earnings quality, forensic accounting and corporate governance that are predictive of fraud. It is the depth of the metrics which comprise the AGR™ model that create a differentiated measure of risk – the risk that the financials and corporate behavior cannot be relied upon to accurately represent the corporation’s performance.

Because AGR™ is an effective measure of identifying unusual accounting and governance practices as they pertain to fraud, it is reasonable to test whether AGR™ can predict control deficiencies. **Figure 2** illustrates the percentile AGR™ rating for companies found to have ICDs versus the entire population.

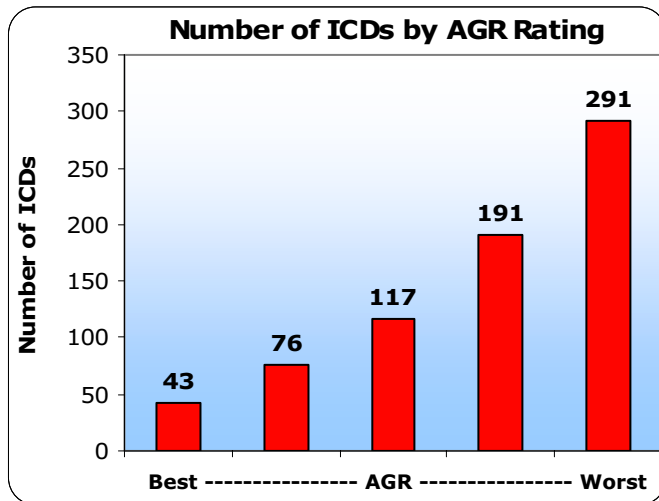
**Figure 2: Average AGR for Companies with ICDs**



Company Standing	AGR™ Percentile
With Control Deficiencies	32
Entire Population	50

The results show that on average, companies found to have ICDs fell within the bottom 1/3 of all rated companies, well below the median. Further analysis observed the distribution of ICDs across AGR™ scores. **Figure 3** below breaks out the number of companies with ICDs by AGR™ for the period 1/2004 – 7/2005<sup>3</sup>.

**Figure 3: Number of ICDs by AGR™ Score**

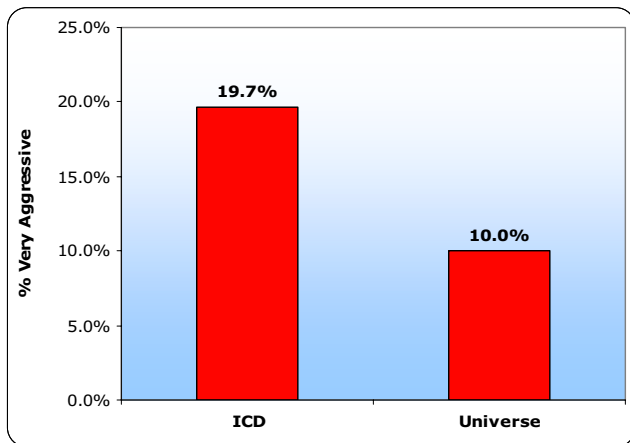


**AGR™ ratings are related to Internal Control deficiencies – as the AGR™ rating worsens, the incidence of ICDs increases.**

The results demonstrate that the incidence of ICDs was highest for the worst rated companies and consistently declined as AGR™ ratings improved. Further, the results illustrate that the worst rated companies are nearly 7 times as likely to face an ICD than the best rated companies.

Lastly, we examined the propensity of companies with ICDs to fall in the worst AGR™ rating group. **Figure 4** below exhibits the proportion of companies facing ICDs that were rated Very Aggressive (the lowest 10% of all companies as rated by AGR™).

**Figure 4: Proportion of Companies with ICDs rated Very Aggressive**



**Companies that have ICDs were twice as likely to fall in the bottom 10% of companies rated by Audit Integrity.**

**Conclusion**

The implementation of Section 404 of the Sarbanes-Oxley legislation has been the subject of furious debate amongst corporations, auditors, regulators and others. While 404 costs have been easier – and painful – to calculate, until recently the benefits have been less clear. A growing body of academic and professional research supports the finding that lack of transparency in accounting and corporate governance has a very significant cost attached to it. Recent research now concludes that corporations with internal control deficiencies (ICDs) as

defined by section 404 – companies which are naturally more susceptible to accounting irregularities – pay the price through:

- **Higher cost of capital** – firms reporting strong internal controls or firms that correct prior internal control problems benefit from lower costs of equity capital of 50 to 150 basis points
- **Lower stock price returns** – companies without ICDs had stock returns of 27.7% over the two-year period since ICDs were first reported, vs. -5.8% returns for companies with ICDs in both years

Academic research and feedback from market participants demonstrates increasingly strong evidence that internal control deficiencies are not well received by capital markets, and companies which fall prey to these deficiencies face higher costs of capital to reflect the additional risk of potential accounting and governance irregularities.

In previous research publications, Audit Integrity's proprietary AGR™ rating has been shown to be predictive of SEC enforcement actions, class action litigation, material restatements and equity returns. New research presented in this article shows a similar relationship between AGR™ and ICDs.

- Companies with the worst AGR™ ratings are 7 times as likely to face ICDs than those with the best AGR™ ratings.
- Companies with ICDs have lower AGR™ scores than the rest of the universe – on average falling in the bottom 1/3 of company ratings
- There is a consistent decrease in the incidence of ICDs for companies with higher AGR™ ratings
- There is substantially higher incidence of Very Aggressive AGR™ ratings for companies with ICDs

Utilizing AGR™ can be an effective way to avoid high-risk companies and establish risk-adjustment factors for a variety of business needs. By reducing exposure to low AGR™ ratings, stakeholders would have avoided a substantial amount of risk for the study period with respect to ICDs.

Audit Integrity provides unique insight into managing risk. For more information please contact us at:

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Footnotes:

1 "The Effect of Internal Control Deficiencies on Firm Risk and Cost of Equity Capital," April 13, 2006, HOLLIS ASHBAUGH-SKAIFE, University of Wisconsin - Madison, DANIEL W. COLLINS, University of Iowa, WILLIAM R. KINNEY, JR., University of Texas, RYAN LAFOND, MIT

2 "Revise 404 for the Market, Panelists Say," Helen Shaw, CFO.com

3 "Checks on Internal Controls Pay Off," The Wall St. Journal Online, 5/8/2006, David Reilly

4 Data compiled from ComplianceWeek.com ~ 750 separate incidents of ICDs were used in this analysis

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